Bounded Rationality and the Concept of Materiality in Securities Regulation – How rational is the “reasonable investor”? (Abstract)

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The concept of materiality – in the EU known as (price) relevance – is key to both the insider trading ban and the continuous disclosure obligation under EU and US securities regulation. The insider trading bans prohibit market participants from trading on non-public, material information. The EU continuous disclosure obligation requires issuers of financial instruments to publish any material information that is not publicly known and directly concerns those issuers. Both EU and US securities regimes measure materiality from the perspective of a “reasonable investor”. However, courts have reached differing conclusions on how rational reasonable investors really are. In the US, courts largely consider the reasonable investor to be a personification of perfectly rational markets. In Germany, the Federal Court of Justice has deemed that reasonable investors take into account the irrational reactions of other market participants, but has neglected to examine whether, by taking such reactions into account, the reasonable investor herself becomes irrational. This presentation offers to answer that question by using a simple market model that incorporates both information traders as well as utilitarian/liquidity traders, i.e., traders who seek out exploitable information versus those who stay rationally uninformed. Perhaps surprisingly, the model shows that the reasonable investor as viewed by the law is in fact perfectly rational, suggesting that EU courts ought to follow the standard applied by US courts.